Economic Update

Committee on the Budget ▪ Majority Caucus
U.S. House of Representatives
Jim Nussle, *Chairman*

309 Cannon House Office Building
Washington, DC 20515 (202) 226-7270
Jim Bates, *Chief of Staff* ▪ www.budget.house.gov

Volume 4, Number 4 11 May 2005

April Jobs Surge Supports Growth Outlook; Tax Revenue Up

Recent data and evidence indicate the U.S. economic expansion remains on track, with continued growth in real gross domestic product [GDP] and improving labor markets. In particular, the solid jobs report for April released last week reduced concerns that the U.S. economy was slowing, as some had suggested.

On the policy front, the Congress passed the concurrent resolution on the budget for fiscal year 2006, setting in place a blueprint for fiscal policies in coming years, and – for the first time in eight years – calling for restraint in mandatory spending programs. Monetary policy continued to be oriented toward gradually raising interest rates, reflecting the outlook for moving toward a higher sustained level of economic activity. Improving data, in turn, have led the Congressional Budget Office [CBO] to boost its estimates of tax revenue – and to reduce the likely deficit – for the current fiscal year.

Recent Data

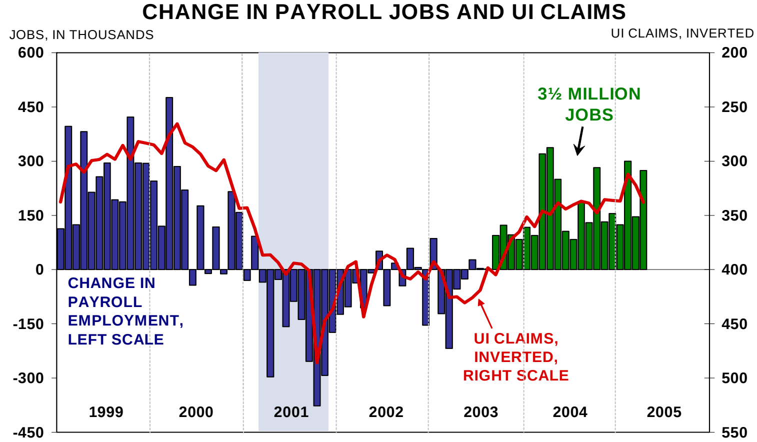
Although the GDP report for the first quarter fell somewhat short of analysts' expectations, strong April employment numbers reinforced the outlook for sustained growth in the economy and helped to allay prior concerns of a potential marked slowdown in the second quarter.

- *Real GDP* grew at a 3.1-percent annual rate in the first quarter, according to advance estimates released by the Commerce Department. Analysts had expected a growth rate above 3.5 percent. Still, it was the fourteenth consecutive quarter of growth following the recession, and the eighth straight quarter above 3 percent. Real consumption spending rose at a 3.5-percent rate; real business equipment and software spending increased at a 6.9-percent rate; and residential investment was up at a 5.7-percent rate. But the trade deficit increased sharply, with real net exports subtracting 1.5 percentage points off the GDP growth rate. Another concern is the large buildup in business inventories: it boosted the first quarter real growth rate by 1.2 percentage points, but sets the stage for a possible equivalent subtraction from growth in the second quarter if businesses slow production to bring inventories back in line.

- *The employment situation* continued to improve in April, as non-farm payroll employment rose by 274,000 jobs and the unemployment rate remained at 5.2 percent. Further, employment gains in February and March were revised up by 93,000 jobs. Payroll employment has now increased by 3½ million jobs since May 2003 (the post-recession low for jobs) – see chart. Other labor data also are showing solid gains. Aggregate production worker hours rose sharply, putting the level of hours at the start of the second quarter at a 4.3-percent annual rate of gain from the first quarter average. New claims for unemployment insurance have been at the lowest sustained levels since November 2000: the 4-week moving average was at 321,500 at the end of April (analysts view claims below 400,000 as a sign of improving labor markets).

- *Other selected data.* The Institute for Supply Management purchasing managers index showed that

CHANGE IN PAYROLL JOBS AND UI CLAIMS



Shaded area represents recession period.

(continued on reverse side)

the manufacturing sector continued to expand in April, but at a slower pace than the strong, sustained rates of the past 2 years. Consumer confidence and sentiment declined in recent months, but remain at levels consistent with moderate growth in a sustained expansion. Home sales are at record highs, though housing starts fell back in March to just more than 1.8 million units at an annual rate.

Blue Chip Outlook

Private Blue Chip forecasters continue to anticipate solid economic growth in the 3.0- to 3.4-percent range through the end of 2006 (see table). Even so, the volatility of recent data, and the composition of first-quarter GDP, have led to reduced real GDP growth forecasts for the second quarter – down to 3.0 percent from the 3.6 percent shown last month. (The most recent survey was conducted before the April jobs report). Blue Chip projections continue to show moderate consumer price index inflation, and a gradual rise in interest rates through the end of next year.

Blue Chip Economic Outlook, May 2005

	2004.4	2005.1	2005.2	2005.3	2005.4	2006.1	2006.2	2006.3	2006.4
	----- Actual -----		*Projection*						
Real GDP Growth	3.8	3.1	3.0	3.4	3.3	3.2	3.3	3.3	3.3
Unemployment Rate	5.4	5.3	5.2	5.2	5.1	5.1	5.1	5.0	5.1
CPI Inflation	3.4	2.5	3.3	2.3	2.4	2.4	2.5	2.4	2.4
3-month Treasury Bill	2.0	2.5	3.0	3.4	3.7	3.9	4.1	4.2	4.2
10-year Treasury Note	4.2	4.3	4.5	4.7	4.9	5.1	5.2	5.2	5.2

Monetary Policy

The Federal Reserve's Federal Open Market Committee [FOMC] met in early May and decided to raise its target interest rate – the Federal funds rate – by one-quarter percentage point to 3 percent, in response to ongoing real growth in the economy. The FOMC has increased this rate target eight times in the past year, each time in quarter-point moves. As reflected in the Blue Chip projections, analysts generally expect the FOMC to continue to raise rates over the next year.

Budget Resolution Adopted; Tax Revenue Up

Earlier this month, the House and Senate passed the concurrent resolution on the budget for fiscal year 2006. The budget represents a blueprint for fiscal policies intended to promote sustained expansion in the U.S. economy, including growing revenue, restrained spending growth, and projected declines in the budget deficit.

- *Low tax burden, but growing revenue.* Although the exact form of tax relief for coming years will be decided by new legislation originating in congressional committees, the budget allows for extending the tax relief of the past 4 years, including pro-growth items such as the lower tax rates on capital gains, dividends, and small business equipment expensing. Over the 2005-10 period, tax revenue is projected to increase, rising from 16.8 percent of GDP to 17.7 percent, close to the post-WWII average of 17.9 percent.

- *Spending restraint.* Under Congress's 2006 budget resolution, discretionary spending authority for regular appropriations is to increase just 2.1 percent – including a 4.8-percent boost for defense, 3.2 percent for homeland security, and a 0.8-percent reduction elsewhere. Mandatory spending growth is to be reduced by $34.7 billion over 2006-10 through reconciled savings – the first such savings since 1997.

- *Deficit reduction.* With growing revenue and spending restraint, the budget projects a reduction in the Federal budget deficit, from $412 billion in fiscal year 2004 to $211 billion in fiscal year 2010 – a decline from 3.6 percent of GDP in 2004 to 1.3 percent in 2010. The resulting projected debt burden rises only slightly, to 39.8 percent of GDP in 2007, and then falls to 39 percent by 2010. These deficit and debt levels are well within the ranges for what economists typically view as a "sustainable" fiscal policy that would not have significant adverse consequences for the performance of the economy. Even Fed Chairman Alan Greenspan has defined a benchmark level of the deficit this way: "[O]ne standard is, if the unified budget deficit is 2 percent of GDP or less, it stabilizes the ratio of debt to GDP. So if you are looking at a straightforward numerical type, that's not a bad one."

Separately, CBO said tax revenue is coming in stronger than anticipated – especially for taxes on corporate profits. The results point to a likely lower deficit than anticipated – by about $50 billion for fiscal year 2005 – putting the rough estimate for the deficit at $350 billion this year.

Prepared by . . . . John H. Kitchen
Chief Economist